# REPORT

of Findings

of

# Administrator

of

# Consumer Affairs

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pursuant to

CONCURRENT RESOLUTION NO. S. 319

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Adopted March 30, 1977

REPORT RECEIVED

The following was received:

To: The General Assembly of the State of South Carolina

# REPORT OF FINDINGS
of
ADMINISTRATOR OF CONSUMER AFFAIRS
pursuant to
CONCURRENT RESOLUTION NO. S. 319
adopted March 30, 1977

## TO REQUEST THAT THE ADMINISTRATOR OF THE DEPARTMENT OF CONSUMER AFFAIRS INVESTIGATE ANY CONFLICTS BETWEEN THE SOUTH CAROLINA USURY STATUTES AND THE CONSUMER PROTECTION CODE AND TO REPORT TO THE GENERAL ASSEMBLY HIS FINDINGS.

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*Questions Presented*

(1) To what extent have the South Carolina usury statutes been preempted by the Consumer Protection Code?

(2) What conflicts or confusion exists, if any, with respect to the applicability of various statutory provisions relating to money and interest?

I. *Terminology and Observations*

Section 1.108(1) of the Consumer Protection Code provides that This Act prescribes *maximum charges* for *all creditors,* except...*those excluded (Section 1.202),* extending consumer

credit including...*consumer loans* (Section 3.104), and displaces existing limitations on the powers of those creditors based on maximum charges. (Emphasis added)

A. *Terminology*

Before going further it will be helpful to note the import of certain terminology.

(1) *"Maximum charges"* is not synonymous with interest or service charge or finance charge. It *includes* these charges but also includes all other charges made as an incident to the extension of credit as well as other credit related charges such as insurance premiums, delinquency charges, deferral charges, etc..

(2) *"...All creditors, except...those excluded (Section 1.202)"*

Section 1.202 excludes from the maximum charge provisions of the Code

(a) loans to government entities;

(b) loans under public utility or common carrier tariffs to the extent that such charges are regulated by a state or federal agency;

(c) loans by pawnbrokers;

(d) loans by insurance agents and premium service companies to finance premiums;

(e) loans by finance companies licensed under Act 988 of 1966;

(f) loans for agricultural purposes;

(g) loans to students for educational purposes; and

(h) loans by credit unions.

Thus, except as enumerated above, the Code prescribes maximum charges for all creditors making *consumer loans* and preempts all prior inconsistent law pertaining thereto.

(3) *"Consumer Loan"* is defined in Section 3.104 as follows:

(A) Except as provided in subsection (B), 'consumer loan' is a loan made by a person regularly engaged in the business of making loans in which:

(1) the debtor is a person other than an organization;

(2) the debt is incurred primarily for a personal, family or household purpose;

(3) either the debt is payable in installments or a loan finance charge is made;

(4) either the principal does not exceed twenty-five thousand dollars or the debt is secured by an interest in land.

(B) 'Consumer loan' does not include a loan primarily secured by a first lien which is a *purchase money security interest in land.* (Emphasis added)

(4) *"Purchase money security interest in land"* means a security interest

(a) taken or retained by the seller of the land to secure all or part of its price; or

(b) taken by a person who by making advances or incurring an obligation gives value to enable the debtor to acquire rights in or the use of land if such value is in fact so used. Section 1.301(21)

(5) *"Land"* is not defined in the Code.

B. *Some observations*

(1) Loans which are *not* "consumer loans" as defined above include

(a) loans made by a person who is not regularly engaged in the business of making loans;

(b) loans to an "organization"-corporation, trust, estate, partnership, cooperative or association [See Section 1.301(11)];

(c) loans made primarily for a commercial or business purpose or use;

(d) loans (other than real estate loans) over $25,000; and

(e) first mortgage purchase money real estate loans of any amount.

(2) Real estate loans which *may be* consumer loans, regardless of size, are

(a) real estate loans (including purchase money loans) primarily secured by other than a first mortgage; and

(b) first mortgage real estate loans other than purchase money loans.

(3) The terms "consumer loan" and "installment loan" are not synonymous. A single payment loan may be a consumer loan and an installment loan is not always a consumer loan.

(4) A loan is not a consumer loan unless it meets *all* of the criteria set forth in the definition [Section 3.104(1)].

(5) A first mortgage purchase money real estate loan is not a consumer loan even though it meets all of the criteria set forth in

subsection (1) of Section 3.104 [because it is specifically excluded from the definition in subsection (2)].

(6) The maximum charge provisions of the Consumer Protection Code do not apply to a loan which is excluded by Section 1.202 even though it is a consumer loan as defined in Section 3.104.

(7) *All* consumer loans made by *all* lenders (except those excluded by Section 1.202) are subject to the maximum charge provisions of the Consumer Protection Code.

(8) The maximum charge provisions of the Consumer Protection Code do not apply to "commercial loans" but such loan rates are affected by Part 6, Article 3 of the Code. (*Note* the term "commercial loan" does not appear in the Code. It is used in this discussion for simplification and refers to all loans which are not consumer loans and are not excluded by Section 1.202).

(9) With one exception the parties to a "commercial loan" may agree in writing that the loan is subject to the Consumer Protection Code, in which case the maximum charge provisions of Part 2 (but not Part 5) of Article 3 of the Code are applicable. The single exception is a loan primarily secured by a first lien which is a purchase money security interest in land. (See Section 3.601)

(10) With the same exception as above the parties to a "commercial loan" of $50,000 or more "may contract for the payment by the debtor of any finance or other charge." (See Section 3.605)

II. *Extent of Preemption*

The extent to which the general and special usury laws have been preempted by the Consumer Protection Code is as follows:

(1) Loans which are excluded (by Section 1.202) from the maximum charge provisions of the Consumer Protection Code and those which are excluded from the Code's application altogether remain, of course, subject exclusively to the laws which provided for such charges prior to enactment of the Code and, to the extent, are not affected by the Code.

(2) Loans which are "primarily secured by a first lien which is a purchase money security interest in land" remain subject exclusively to pre-Code law, regardless of amount or by whom or to whom made. Such loans are not affected by the Consumer Protection Code.

(3) Except as stated in (1) and (2) herein, all consumer loans are subject exclusively to the maximum charge provisions of the Con-

sumer Protection Code regardless of who makes such loans. To the extent that any pre-Code law applied to such consumer loans all such pre-Code law is preempted.

(4) Except as stated in (1) and (2) herein, loans other than consumer loans, of $50,000 or more are exempt from all maximum charge limitations—"the parties may contract for payment by the debtor of any finance or other charge." Thus to the extent that pre-Code law applied to such "commercial loans" all such pre-Code law is preempted.

(5) Except as stated in (1) and (2) herein, loans other than consumer loans may be treated as consumer loans and made subject to Code provisions by written agreement; in which case the maximum charge provisions of Part 2 (but not Part 5) of Article 3 of the Consumer Protection Code will apply. Absent such written agreement such loans (of $50,000 or less) remain subject to pre-Code law respecting such charges. (Loans over $50,000 are exempt from rate and charge limitations).

(6) All preemptions discussed herein extend only to the extent that such pre-Code law provides "limitations on powers... based on maximum charges." [Section 1.108(1)] In no case does the Consumer Protection Code preempt or displace *any other* powers of "...savings banks, savings and loan associations, or other thrift institutions or insurance premium service companies...." [Section 1.108(3)]

III. *Areas of Potential Confusion or Conflict*

The South Carolina Consumer Protection Code is the Uniform Consumer Credit Code with certain South Carolina modifications. All of the confusion or uncertainty about the Consumer Protection Code's application arises out of a major modification respecting "commercial" loans and loans secured by real estate.

Section 3.105 of the Uniform Code provided that a real estate loan which would be a consumer loan but for the fact that it is "primarily secured by an interest in land" is a consumer loan if the rate of loan finance charge contracted for exceeds 10% APR (now 12% APR), otherwise it is not a consumer loan and is not subject to the Consumer Protection Code.

The comment under that Uniform Code Section states that

> The purpose of this section is to exclude the ordinary home mortgage from all provisions of this Act...; however, this Act is intended to include as consumer loans high rate loans which

are characteristic of the second mortgage small loan business. Because the ordinary home mortgage invariably has a loan finance charge below 10%, the exclusion has been based on the amount of the loan finance charge.

Section 3.605 originally read: "With respect to a loan other than a consumer loan or a consumer related loan, the parties may contract for the payment by the debtor of any loan finance charge."

The comment under this section reads, in part

> . . . It is impossible to measure how much is too much interest with respect to large business transactions. If the limit is set so high as to provide adequately for speculative business ventures the limit becomes virtually meaningless for most transactions. If it is set at a level close to the top of the range for most business transactions, it will preclude loans for extraordinary ventures.

Thus, under the *uniform* Code all real estate loans, regardless of amount or priority of the mortgage were either consumer loans or consumer related loans subject to the 18% Code ceiling or "other than consumer loans" and subject to no ceiling. All loans other than consumer loans or consumer related loans, regardless of amount or security, were subject to no ceiling. All prior law prescribing maximum charges for such loans (except those excluded by Section 1.202) were to be repealed. This approach would have removed the potential for conflict and confusion.

Under the modified South Carolina version, called the Consumer Protection Code, a loan "primarily secured by a first lien which is a purchase money security interest in land," remains subject exclusively to pre-Code law. This includes the "ordinary home mortgage" as well as commercial real estate mortgages, regardless of amount. Likewise, loans other than consumer loans, of less than $50,000 remain subject to pre-Code law, except where a written agreement applies Code provisions. These modifications precluded *repealing* any prior usury law and introduced the potential for conflict and confusion.

The problems which have surfaced have to do mainly with just two areas:

(1) The phrase "primarily secured by a first lien which is a purchase money security interest in land" is not defined in the Con-

sumer Protection Code. Nor are the terms "*primarily* secured" or "land" defined; and

(2) Some statutes limiting the types of loans a savings and loan association may make and which are not repealed or preempted have the effect of restricting rates indirectly.

With respect to the problem area first mentioned, questions arise as to whether loans such as the following are "primarily secured by a first lien which is a purchase money security interest in land":

(a) a construction loan to build a residence for the borrower on a lot already owned by him;

(b) a loan to buy a mobile home which will be "permanently affixed" to a lot owned by the borrower;

(c) a second mortgage loan made by a lender who also holds the purchase money first mortgage. Which mortgage is the *primary* security for the second loan?

d) a first mortgage loan to buy a condominium—is this an interest in *land?*

e) a first mortgage loan to pay off a purchase money first mortgage where additional cash is advanced or no additional cash is advanced. For example, owner has large equity in home and wishes to refinance and use equity for home improvement or owner merely refinances existing balance;

f) *two* purchase money loans made by the same lender, one a $10 loan secured by a first mortgage and the balance of the purchase price secured by a second mortgage. Would the answer be different if the two loans were made by separate (but related) corporations?;

g) second mortgage loans made to a new purchaser to enable him to buy prior owner's equity and assume his purchase money first mortgage to the same lender.

With respect to the second problem area, Chapter 7, Title 8 of the South Carolina Code of Laws (Sections 8-600 through 8-626) apply specifically to savings and loan associations. Some provisions therein raise some difficult questions.

Section 8-603 provides that a savings and loan association may make "direct reduction of principal loans." The statute does not define "direct reduction of principal loans," nor does it indicate whether or not such loans are to be secured by real estate or whether by a first or second mortgage. It assumes (but does not specify) that such loans will be secured by a "mortgage" of some type and class. The section does not prescribe a maximum charge

but prescribes a *method* of applying payments to reduction of principal, which is to some extent inconsistent with some requirements of the Consumer Protection Code.

Section 8-603.1 provides that:

> No building and loan association may make loans under the provisions authorized by law to banks, banking houses or other persons conducting business in the nature of a bank or banking house, except in the usual way of lending to individuals, without discount, and showing the evidence of the indebtedness of such loans to be by promissory notes or bonds secured by mortgages of real estate or other security.

This section is ambiguous. It can be read as providing that a savings and loan association may make loans which banks may make *provided* that such loans are made in the usual way of lending to individuals, without discount, and are evidenced by a note or bond and secured by mortgages of real estate or other security.

If this is the meaning of Section 8-603.1 it would appear to authorize a savings and loan association to make consumer loans under the Code since such loans are "authorized by law to banks." The section can also be read as merely prescribing the manner of lending to banks. If that is the meaning of the section, however, why does the "Home Improvement Loan Act of 1956" commence with the words "Regardless of the provisions of §8-603.1"? Clearly a home improvement loan under "Title 1 FHA" is not a loan *to a bank.* (See Section 8-603.2).

The lack of clarity in these sections gives rise to questions which cannot be conclusively answered:

a) Must all loans made by a savings and loan (except a mobile home loan) be a "direct reduction of principal loan"?;

b) Does the term "direct reduction of principal loans" encompass consumer loans as defined in the Code?;

c) Are there consumer loans which would not be "direct reduction of principal loans"? If so, which?

d) If a savings and loan association may make consumer loans under the Consumer Protection Code, may such lender disregard the inconsistent application of payments provisions of Section 8-603 in order to comply fully with that Code?

e) Would a loan in compliance with the Consumer Protection Code be made "in the usual way of lending to individuals"?

IV. *Residual Application of Specific Statutes*

Section 8-4—*Fee authorized in lieu of interest.*

This was a "small loan law" for banks. It provided a graduated rate ranging from about 21% APR on a loan of $150 to about 59% on a loan of $50. Such loans which are consumer loans are now subject *exclusively* to the Consumer Protection Code. With respect to such loans this section may be regarded as repealed. If a bank should make such a loan which is *not* a consumer loan this section would still apply.

Section 8-233—*Interest Rate on Installment Credit Plans*

The first paragraph of this section was the "Installment Loan Act." The second paragraph was the "Revolving Loan Act," sometimes called the "bank card" or "credit card" law.

Both of these acts applied to consumer and "commercial" loans alike. The installment loan provision provided a rate of "7% add-on" (approximately 12-3/4% APR) for loans which were "payable in installments." The revolving loan rate was 1-1/2% per month (18% APR). To the extent that these sections applied to consumer loans they may be regarded as repealed, but lenders may continue to make other than consumer loans under these sections.

Section 8-3—*Maximum Interest Rates; Exceptions*

Until 1935 this was "the usury statute." It prescribed the ceiling on interest which could be charged "upon any contract arising in this State for the hiring, lending or use of money or other commodity...." It is no longer a ceiling for any credit which is not a loan primarily secured by a first lien which is a purchase money security interest in land. ("Commercial" loans under $50,000 *may* be made under the Consumer Protection Code. Such loans over $50,000 are exempt from rate ceilings.) Its residual application to real estate loans, however, is somewhat problematic, thanks to a series of amendments to this section and Section 8-233.

In 1935 (Act No. 270) the legislature exempted from the usury statute loans of $1,000 or less which were payable in installments. This Act was known as the Installment Loan Act and is codified as Section 8-233.

In 1962 (Act No. 762) the $1,000 ceiling of the Installment Loan Act was raised to $7,500, and the Act was *made inapplicable to real estate loans.*

In 1966 (Act No. 1042) Section 8-233 was deleted and a new provision was enacted which had no ceiling and which *omitted* the real estate restriction which had been introduced into the law in 1962.

The title of the 1966 Act, however, made reference to loans "secured by other than real estate mortgages."

In 1968 (Act No. 1265), Section 8-233 was again deleted in its entirety and a new provision enacted with no ceiling, *no real estate exclusion* and no reference to real estate loans in the title.

In 1973 (Act No. 839) Section 8-3 was amended to provide that with respect to "loans secured by *first* mortgages on real estate" (until June 30, 1975)* the parties may contract for

9% on loans of $1 to $50,000;
10% on loans of $50,001 to $100,000;
12% on loans of $100,001 to $500,000; and
any amount on loans in excess of $500,000.

* The June 30, 1975 expiration date was extended in 1975 to June 30, 1977.

The General Assembly apparently assumed that second mortgage loans could be made under the Installment Loan Act (Section 8-233) since it is not likely that it was intended to leave second mortgage rates at 8% while raising first mortgage rates to 9%, 10%, 12%.

It should be noted that the 1962 act excluded *all* real estate loans, without regard to whether they were secured by first or second mortgages. Likewise when the real estate loan restriction was removed no distinction was made between first and second mortgages. If Section 8-233 applied to second mortgages it applied equally to first mortgages or so it would seem.

But if Section 8-233 applied to first mortgage real estate loans why was Section 8-3 amended at all? The legislative history does not answer this question. One possible explanation, however, may be found in a 1968 Attorney General's opinion which stated that:

> ...State chartered banks may discount or add on interest under Section 8-233 of the Code, notwithstanding the fact that the loans in question are secured by mortgages on real estate. On notes secured by mortgages on real estate, State chartered building and loan associations may not discount or add on interest; they are limited to repayment on the direct reduction of principal basis which precludes the discounting or adding on of interest to such notes.

Opinion of the Attorney General written to the Commissioner of Banking on April 18, 1968, at page 3.

A *proviso* which also appeared in the 1973 amendment to Section 8-3 provides

> that nothing contained herein shall limit or prohibit the type of collateral, rate of interest, charges, fees or prepayment provisions on extensions of credit made pursuant to *any other statutes of this state.* (Emphasis added)

It is certainly arguable that this *proviso* expresses an intent to preserve the applicability of Section 8-233 to real estate loans made by lenders who were permitted to lend under that Act, while increasing the rates in Section 8-3 to the market level for loans made by savings and loan associations which, according to the Attorney General, could not make loans under Section 8-233.

Loans which are "primarily secured by a first lien which is a purchase money security interest in land," regardless of size and whether used to purchase a residence or a factory or whatever, are *not* affected by the enactment of the Consumer Protection Code. All such loans are subject to either Section 8-3 or 8-233, unless exempted by one of the *provisos* in Section 8-3 or by Section 8-8, Section 8-604 or Sections 36-601 through 36-603. Whether the controlling statute is Section 8-3 or Section 8-233 depends upon how one interprets the 1968 amendment to Section 8-233 and the subsequent amendment to Section 8-3 in 1973.

In any event it will be observed that this confusion was *not caused* by enactment of the Consumer Protection Code. It resulted from numerous "patchwork" amendments to the general usury laws in response to economic pressures which saw real estate loan rates increase from the 4%-5% levels of the 1940's and '50's to reach and exceed the traditional 7% interest rate ceiling in the 1960's and '70's. It was this kind of confusing patchwork that the *Uniform* Code sought to eliminate. Indeed, the confusion regarding loans "primarily secured by a first lien which is a purchase money security interest in land" was caused by an effort to *preserve* the application of these usury statutes to "ordinary home mortgages."

Respectfully Submitted,
/s/ Irvin D. Parker
Administrator of
Consumer Affairs

Received as information.